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SUBJECT: IMF OFFERS PRAISE AND WARNINGS TO CARIBBEAN GOVERNMENTS

11. (U) SUMMARY: While commending strong Caribbean growth and responsible fiscal and monetary policies, visiting IMF officials urged regional governments to adopt proactive measures to reduce current account deficits and public debt while economies are strong. They also recommended eliminating tax incentives for foreign investors as a region and advocated a strategic approach to economic diversification in order to ensure future Caribbean economic success. T&T is in an especially strong position to adopt many of these recommendations; whether this will happen in an election year remains to be seen. END SUMMARY.

12. (U) International Monetary Fund (IMF) Deputy Director of the Western Hemisphere Department Markus Rodlauer and IMF Trinidad and Tobago (T&T) Mission Chief Max Alier offered both praise and warnings to Caribbean governments as they publicly launched the IMF's April 2007 World and Regional Economic Outlook publications at the T&T Central Bank in Port of Spain May 7.

The Good - Fiscal and Monetary Policy

13. (U) Despite a U.S. economic slowdown, Caribbean countries experienced robust eight percent growth in 2006, led by T&T's region-topping 12 percent real GDP growth. The IMF predicts T&T will continue to drive Caribbean growth with 6.5 to 7 percent growth in 2007 as new production comes onstream. The IMF economists praised Caribbean governments for implementing robust monetary and fiscal policies, which have helped to keep inflation low in many countries despite the pressures of booming economies and rising fuel prices. Even in countries, like T&T, which experienced double-digit inflation in 2006, Alier reported that indicators of core inflation are down. They also commended Caribbean governments for policy successes in the past decade, including tax system modernization, reform of social security schemes, closure of loss-making industries like sugar and bananas, disaster mitigation policies like the Caribbean Catastrophic Risk Insurance Fund, and debt restructuring.

The Bad - Current Account Deficits and Debt

14. (U) Despite positive growth rates and high remittances, especially in times of natural disasters, the IMF found that current account deficits in the Caribbean (other than T&T) have increased to an average of 15% of GDP, as global energy prices have increased more than non-fuel commodities since 2002. Some Caribbean countries have tried to use improved growth to strengthen their fiscal position, but they remain among the most indebted emerging market economies, due in part to the frequency and high costs of natural disasters. Rodlauer pointed out that "unsafe" levels of public debt are costing the Caribbean both in interest expenditures and lost

investment.

Policy Challenges and Recommendations

¶5. (U) The erosion of trade preferences in banana and sugar, coupled with declining Official Development Assistance (ODA) from traditional donors, aging populations and vulnerability to costly natural disasters, are a few of the ongoing challenges for Caribbean governments highlighted by the IMF. The economists urged Caribbean governments to adopt proactive measures to address these issues while economies are performing well, to avoid future sharp adjustments. They also noted that given the region's vulnerability to natural disasters, governments needed "fiscal room" to respond flexibly - another reason to reduce public debt.

¶6. (U) The IMF also provided policy recommendations, such as eliminating costly and ineffective tax incentives for foreign investors throughout the Caribbean. The economists pointed to the Caribbean's ten-year 10.8% estimated tax gap (the difference between what statutory tax rates should yield and what is actually collected) and noted that in the Caribbean, the business climate and macroeconomic factors play a larger role in attracting FDI than tax incentives. They deemed tax holidays particularly harmful and recommended using depreciation allowances instead. Saying that the "only road to success was through regional integration" and promoting CSME, Rodlauer urged Caribbean governments to work together on this issue. He also encouraged strengthening the investment climate by improving human capital and the health and legal systems, as the Caribbean performed worse than other developing regions in global competitiveness and in ensuring that contracts are enforced.

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¶7. (U) While both T&T Central Bank Deputy Governor Shelton Nicholls and Dave Seerattan from the Caribbean Centre for Monetary Studies (CCMS) advocated economic transformation and diversification into new industries to moderate the effect of commodity price fluctuations, Rodlauer promoted more limited, strategic diversification. He noted that small open economies historically find success in niche markets, supported by government policies that allow flexibility for labor and investment to shift sectors nimbly as market conditions dictate.

¶8. (SBU) COMMENT: As one of the few Caribbean countries with a current account surplus and comparatively low public debt, Trinidad & Tobago is in the economic position both to implement proactive policies that address the challenges the IMF highlighted, like a recently approved Heritage and Stabilization Fund, and to lead on regional integration. However, in this election year for T&T, further moves toward fiscal discipline and reducing public debt seem improbable. Neither do we anticipate that GOTT leaders will heed the IMF's suggestion to scale back ambitions for wholesale diversification and focus on strategic niche industries. The GOTT is well down the road with a series of new energy-based industrial projects in petrochemicals, steel, and aluminum, at the same time promoting seven non-energy industries in an effort to reduce dependence on the energy sector. END COMMENT.

AUSTIN